
CALIFORNIA BUDGET REPORT

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Budget Shortfall Pegged at \$16 Billion *Legislative Analyst Proposes Comprehensive Budget Solution*

Thanks to the Legislative Analyst, Elizabeth Hill, and the fast reading of our new intern, Matthew Christy, you can finally figure out what the Governor proposed, what the LAO thinks of the Governor's proposed budget and—maybe most interesting—what the LAO thinks the Legislature should adopt as a budget plan.

Here is our short summary of what the LAO reports says:

- **Budget shortfall increases to \$16 billion.** A budget shortfall of \$14.5 billion (in January) has now increased to \$16 billion! That's about a 10 percent jump in the size of the shortfall in just 30 days! The LAO finds lower tax receipts (income, sales and bank and corporation) than the Governor estimated, plus lower tribal gaming revenues than assumed.
- **The back end of 2008 may have slightly better economic news than the first part of the year.** However, "...significant improvement will likely not come until 2009." And that's the good news!

Note: One typically gloomy legislative budget staffer told us that some are estimating another \$1 billion to \$3 billion added to the shortfall by May! Stayed tuned to see who is right.

- **Our budget plan is better than the Governor's Plan.** At least, that's what the LAO is saying. Details of the LAO budget appear at the end of this memo.

Here is how you can find copies of all three budget reports from the LAO:

Highlights of the 2008-09 Analysis

http://www.lao.ca.gov/analysis_2008/highlights/pandi_highlights_022108.pdf. This is the short version and the one that harassed reporters and lobbyists are looking at. In 16 pages you get enough information to make your editors or clients semi-happy.

The 2008-09 Budget: Perspectives and Issues,

http://www.lao.ca.gov/analysis_2008/2008_pandi/pandi_08.pdf. Get to this ASAP, since it is the

LAO suggested alternative budget. Although 170 pages, it is well worth reading in detail, since many of the LAO’s suggestions will be the focus of budget hearings. You can bet your bottom dollar that the suggestions of hard cuts (and there are many) will make legislators wince. And the suggestions of increased taxes and fees will make Republicans crazy and most Democrats nervous. All in all, not a bad way to get everyone’s attention.

Analysis of the 2008-09 Budget Bill,

<http://www.lao.ca.gov/laoapp/Analysis.aspx?year=2008&chap=0&toc=4>. This is the detailed look at the Governor’s proposed budget, in 700 or 800 pages (we did not have time to add them up). This is an impressive effort.

Some interesting charts from the LAO

Before we talk about the LAO’s own budget plan—which is the most interesting one we have seen in a good long time—take a look at some contextual charts:

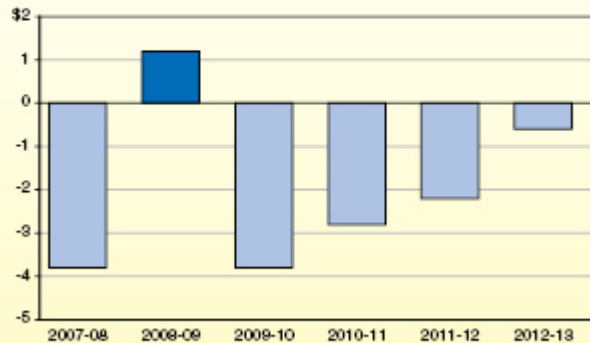
| Figure 2 | |
|---|--|
| How the Governor’s Budget Closes the 2008-09 Shortfall | |
| <i>(In Millions)</i> | |
| | Reserve as of June 30, 2009 |
| Administration’s Definition of Shortfall | -\$14,479 |
| Budget Solutions | |
| Reduce Proposition 98 spending: | |
| 2007-08 reduction | \$400 |
| Suspend 2008-09 minimum guarantee | 4,825 ^a |
| Issue additional deficit-financing bonds | 3,313 |
| Accrue 2009-10 revenues to 2008-09 | 2,001 |
| Suspend transfer to Budget Stabilization Account | 1,509 |
| Reduce Medi-Cal local assistance spending | 1,126 |
| UC/CSU reductions (unallocated) | 569 |
| CalWORKs reforms | 463 |
| Early release of prisoners and summary parole | 372 |
| Suspend SSI/SSP cost-of-living adjustments | 323 |
| Other solutions | 2,356 |
| Governor’s Budget Estimate of 2008-09 Reserve | \$2,778 |

^a The administration proposes a \$4 billion suspension. Due to the way it built its baseline budget, it shows savings of a somewhat higher amount.

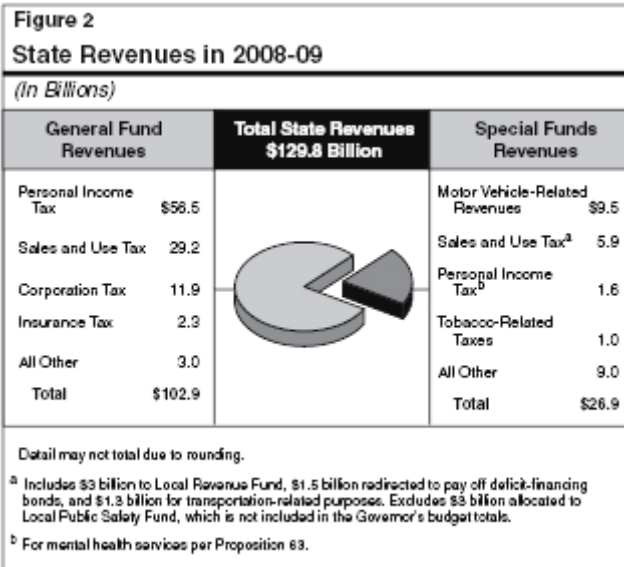
The first chart (*Perspective and Issues*, p. 6; hereafter “P&I”) is a good, short summary of what the Governor proposed. You can see from this that borrowing and one-time fixes are the lion’s share of the overall solution, although some real cuts are also included.

Figure 1
Operating Shortfalls Return After 2008-09
Under Governor's Budget

General Fund
(In Billions)



This may be one of the most interesting charts in the LAO report (*P&I*, p. 11). It shows that even if the Legislature does exactly what the Governor proposes, the state will face ongoing (albeit, slightly declining shortfalls) through 2012-13. Remember: the shortfall disappears or declines only if the Legislature and Governor approve no new spending (hah!) and make no additional tax cuts (double hah!).



Keep this chart (*P&I*, p. 49) handy. It is about the only time you'll see what the budget techies call "Total State Revenue" or "State Own-Source Revenue". This adds up to \$129.8 billion, comprised of the General Fund and selected Special Funds. Keep in mind that the total amount of money that comes to, through, by or from the state to individuals and local governments in California is in excess of \$300 billion annually. We never talk about the funds on top of the Total State Revenue because, allegedly, they are legally committed to specific spending and for all practical purposes "do not exist" (e.g., federal funds, bond funds, retirement funds, debt payments, etc.). Don't ask us

to defend this “close your eyes and pretend that we are not spending 55 percent more” money, but that is what everyone does.

There is no surprise that the LAO, along with everyone else in the state, agrees that the downturn in the housing market and high gasoline prices, which help explain the poor economy in the state, are likely to be with us for some time.

Some charts on spending

OK, we know there is not enough money to do everything we want to do, but what are we planning on spending?

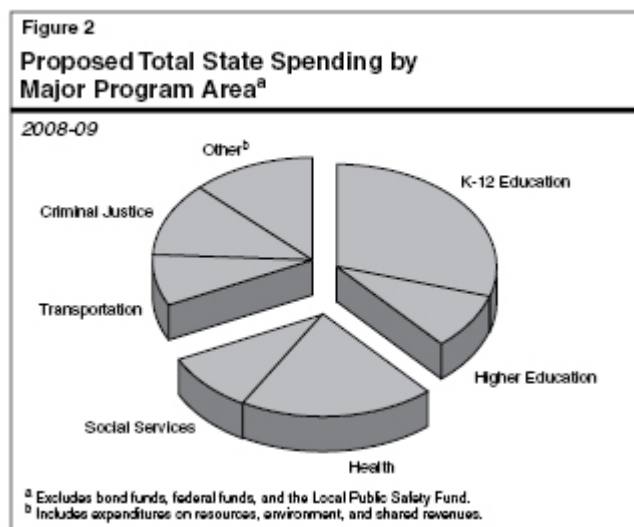
Figure 1
Governor's Budget Spending Totals

(Dollars in Millions)

| | 2007-08 | 2008-09 | Change | |
|----------------------------|------------------|------------------|-----------------|--------------|
| | | | Amount | Percent |
| Budget Spending | | | | |
| General Fund | \$103,373 | \$100,998 | -\$2,375 | -2.3% |
| Special Funds ^a | 28,836 | 27,774 | -1,062 | -3.7 |
| Totals | \$132,209 | \$128,772 | -\$3,437 | -2.6% |

^a Reflects LAO adjustments as detailed in text.
Detail may not add due to rounding.

Yes, Virginia, you do read this correctly (*P&I*, p. 72): the state spending exceeds revenues coming in this year and next.



Total State Spending! Total State Spending! Total State Spending! Yes, Virginia, this chart (P&I, p. 73) tells you how the money is spent –but it includes only the General Fund and Special Funds (see footnotes a and b). If you want to know why everyone claims that “education is getting 30, 35, 43 percent of state funds,” you just have to remember that they use different comparisons. This chart shows K-12 gets about 30 percent of the total (higher education is on top of that). But if you compared it to the General Fund, K-12 education would get about 35 percent of the total.

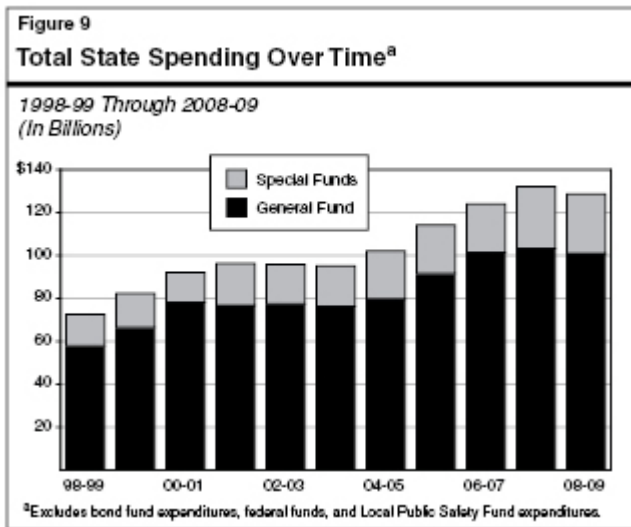
Figure 3
General Fund Spending by Major Program

(Dollars in Millions)

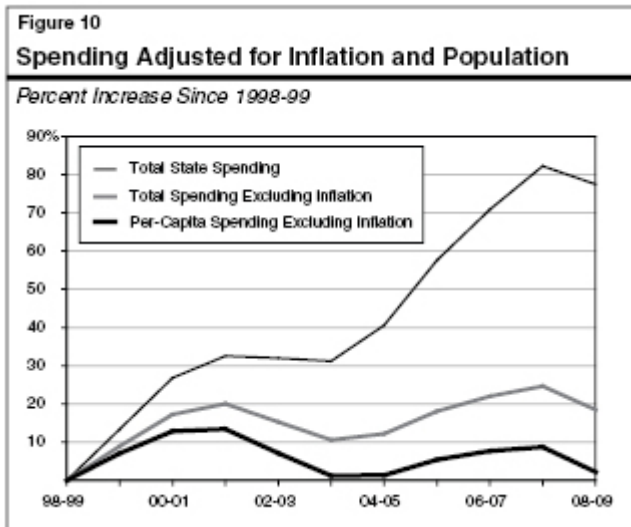
| | Actual 2006-07 | Estimated 2007-08 | Proposed 2008-09 | |
|--------------------------------------|-------------------|----------------------|------------------|-------------------|
| | | | Amount | Percent Change |
| Education | | | | |
| K-12 Proposition 98 | \$37,264 | \$37,473 | \$35,461 | -5.4% |
| Community Colleges Proposition 98 | 4,030 | 4,116 | 4,027 | -2.2 |
| UC/CSU | 5,883 | 6,231 | 6,035 | -3.1 |
| Other | 4,120 | 6,027 | 5,587 | -7.3 |
| Health and Social Services | | | | |
| Medi-Cal | \$13,406 | \$14,064 | \$13,585 | -3.4% |
| CalWORKs | 2,018 | 1,481 | 1,547 | 4.5 |
| SSI/SSP | 3,534 | 3,641 | 3,748 | 2.9 |
| In-Home Supportive Services | 1,474 | 1,630 | 1,633 | 0.2 |
| Other | 8,580 | 8,762 | 8,786 | 0.3 |
| Criminal Justice | \$11,802 | \$13,036 | \$13,122 | 0.7% |
| Transportation | \$2,980 | \$1,439 | \$1,485 | 3.3% |
| All Other | \$6,323 | \$5,474 | \$5,983 | 9.3% |
| Totals | \$101,413 | \$103,373 | \$100,998 | -2.3% |

Boring old numbers! This is the General Fund and everyone talks about this a lot.

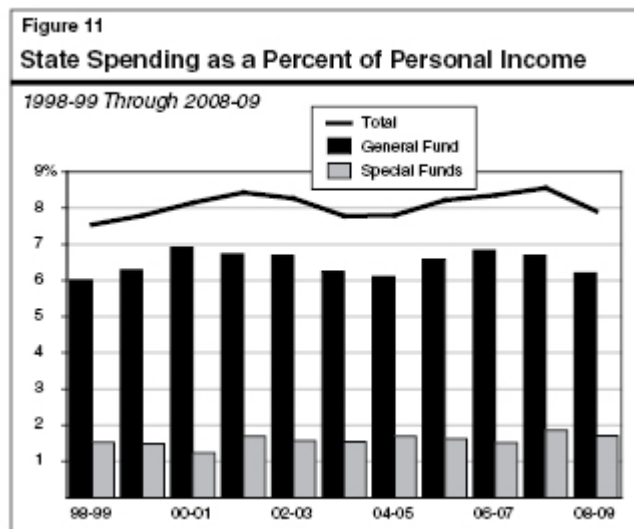
And now for some budget context



This is the fun stuff (*P&I*, p. 83). Good economic times, bad economic times, the trend of spending is up!



But the trend of increased spending (again, “total state spending”) looks outrageous until you exclude inflation and try to use per-capita spending (*P&I*, p. 84).



And if you look at state spending as a percent of personal income (some economists argue this is the most valid way of looking at things), you see that spending over time is relatively constant, and declining for the past two years (*P&I*, p. 85).

Which brings us to the real question:

Why are these annual budget fights so nutty, and what should we do about it? The LAO's proposal...

And here is where the LAO decided to make a dramatic shift in emphasis. For the first time in our memory, LAO has presented its own version of the overall budget. Sure, in past years the LAO has always made recommendations, and often include very detailed discussion of proposals. But the LAO has shied away from laying out a full plan. This year, however, Elizabeth Hill (polite as always) appears to have concluded that the Governor's budget proposal is a fake or so technically confusing that unless the LAO presented a creative plan, no member of the Legislature was going to step up to the plate.

You have to read the full LAO discussion (*P&I*, pps. 87-176), but here is our choice for the best starting chart:

We throw this chart in to show you the overview of the LAO proposal: borrowing, revenue raising, realignment and cuts.

Figure 3

**LAO Alternative Budget:
Major Savings Proposals in 2007-08 and 2008-09**

(In Millions)

| | Savings |
|---|----------------|
| Deficit-Financing Bonds | |
| Issue additional bonds (Governor's proposal) | \$3,313 |
| Suspend Budget Stabilization Account transfer (Governor's proposal) | 1,551 |
| Revenues | |
| Reduce dependent credit | \$1,330 |
| Limit research and development credit | 335 |
| Limit net operating loss carry forwards | 330 |
| Other revenue changes | 660 |
| Proposition 98 K-14 Education | |
| Fund flat year-to-year budget | \$2,769 |
| Reduce current-year spending to minimum guarantee | 950 |
| Suspend Quality Education Investment Act in 2008-09 | 450 |
| Use Public Transportation Account for 2007-08 Home-to-School costs | 409 |
| Prepay 2008-09 settle-up | 150 |
| Parole Realignment | \$483 |
| Other Key Spending Solutions | |
| Reject pay raise for correctional officers in 2007-08 | \$521 |
| Delete SSI/SSP cost-of-living adjustments (Governor's proposal) | 329 |
| Reduce, shift, or eliminate public safety local assistance funding | 278 |
| Change crimes from wobblers to misdemeanors | 250 |
| Shift wildland fire costs to fire protection fee | 239 |
| Cost containment for regional centers (Governor's proposal) | 229 |
| Increase university student fees by 10 percent | 215 |
| Fund UC and CSU nondiscretionary cost increases, but not compact | 207 |

Read this very carefully (P&I, p. 95). Where they agree with the Governor, a note indicates that agreement. You might ask, what is their overall approach? We think it is as follows:

- The budget problems of California are too big to solve by spending cuts or tax increases alone. A combination of approaches is necessary.
- Rather than increase the existing tax rates (see the excellent discussion in P&I, pps. 110-123), cut tax expenditures (aka, "tax loopholes").
- Forget the Governor's proposal to 'accrue' tax revenues of \$2 billion from 09-10 and shove it into the budget year! Too complicated, too many variables and (though the LAO never says so) too embarrassing to consider. A gimmick, not a solution.
- Go ahead and bite the bullet—cut program spending as well as raise revenue.

A summary of the Revenue proposals

| Figure 1 | | |
|---|---------------------|----------------|
| Summary of LAO Revenue-Increasing Proposals | | |
| <i>(In Millions)</i> | | |
| | Revenue Gain | |
| | 2008-09 | 2009-10 |
| Proposals Unique to Personal Income Tax | | |
| Reduce dependent credit | \$1,330 | \$1,070 |
| Eliminate senior credit | 125 | 130 |
| Eliminate partial exclusion of capital gains on small business stock | 55 | 55 |
| Subtotals | (\$1,510) | (\$1,255) |
| Proposals Applying to Both Personal Income and Corporation Tax | | |
| Limit the research and development credit | \$335 | \$290 |
| Limit net operating loss deductions | 330 | 410 |
| Phase out enterprise zone programs | 100 | 120 |
| Eliminate exclusion for "like-kind" out-of-state property exchanges | 25 | 50 |
| Subtotals | (\$790) | (\$870) |
| Unique Sales and Use Tax Proposals | | |
| Eliminate exemptions for industry-specific equipment | \$143 | \$146 |
| Eliminate certain diesel fuel exemptions | 73 | 75 |
| Eliminate exemption for leasing of films and tapes | 65 | 70 |
| Eliminate exemption for custom computer programs | 53 | 48 |
| Adopt one-year standard regarding use tax on out-of-state purchases | 21 | 21 |
| Subtotals | (\$355) | (\$360) |
| Totals | \$2,655 | \$2,485 |

Thank you LAO! Finally a real proposal to fight about. Must make the Democrats very happy. Well, not exactly...

Look at this chart (*P&I*, p. 111) and imagine all the lobbyists in Sacramento trying to figure out whether their clients are hurt or helped by the proposals. Using the old principle of American politics that "taxing me is bad; taxing someone else is OK," and the comparable principle that "my favorite programs should never be cut, only someone else's favorite program," you can see that the LAO leaves no interest group untouched! We love that aspect of the plan. Forget the yacht tax. That generates only \$21 million. This chart shows the big money.

Liberal Democrats support seniors and dependents in families. Do they have the courage to cut seniors and families along the lines of this suggestion? Republicans and business love to cut spending for someone else. What do you bet they object to cutting the exclusion of capital gains for small business, the enterprise zones, the net operating loss deduction?

And the Realignment proposal...

If the spending cuts and revenue increases discussed above were not enough, you have a major realignment proposal. We strongly urge you to read the section in the P&I 145-146. This is a hoot! The LAO decides that the State should not release prisoners, as the Governor proposes.

But, LAO says, the state should finally recognize that state prisons are places where really bad people go—not those guilty of serious, but lesser crimes. The counties should have responsibility for punishing the non-violent offenders, and the state should handle those who are violent. That's not precise, but close enough.

And which prisoners would be sent to the counties?

| Figure 4 | |
|---|---------------------------|
| Parolees Proposed for Realignment to Local Probation | |
| <i>June 30, 2007</i> | |
| Current Offense | Number of Parolees |
| Property Offenses | |
| Second degree burglary | 7,482 |
| Vehicle theft | 7,128 |
| Petty theft with a prior theft | 6,159 |
| Receiving stolen property | 4,920 |
| Forgery/fraud | 4,104 |
| Grand theft | 3,736 |
| Other property offenses | 1,146 |
| Subtotal, Property Offenses | (34,675) |
| Drug Offenses | |
| Drug possession | 19,046 |
| Drug possession for sale | 12,057 |
| Marijuana possession for sale | 1,280 |
| Marijuana sales | 538 |
| Other marijuana crimes | 179 |
| Hashish possession | 49 |
| Subtotal, Drug Offenses | (33,149) |
| Driving under the influence | 3,539 |
| Total, All Offenses | 71,363 |

This chart is worth the price of admission (P&I, p. 132). The prisoners in these categories compose a bit less than 50 percent of all those incarcerated in state prison. Proportionally less than the non-violent folks used to be, but still a big share of state prison costs.

The state currently spends about \$483 million to house these folks. How does the LAO propose that the counties pay for their increased costs? Well, here is the beauty of it all.

Counties receive a projected annual amount of \$495 million from the following sources:

- **About 6 percent of the statewide sales taxes received by cities will be earmarked to pay for the cost of the county handling the transferred crooks!** Not a bad deal in one sense, since incorporated cities in the state have about 85 to 90 percent of the population, and about the same number of convicted felons. But they don't pay much of anything for county costs. This is a grand and glorious fight that has been going on for several decades.
- **About one third of the Vehicle License Fee that is currently held by the Department of Motor Vehicles would be turned over to counties.** This is likely to be the only part of the proposal that local governments really like, since it takes money from the State and gives it to counties.
- **County boards of supervisors would have the authority to review the current \$188 million property taxes received by enterprise (fee-for-service) water and sewer districts and allocate amounts needed to help pay for the realignment.** For those who paused at the notion of fee-for-service districts also receiving property taxes—well, it's another legacy of Proposition 13 (1978). More details if you like.

We hesitate to mention this, but the LAO even credits one of the *California Budget Report* authors for this approach—if not the idea itself, likening it to the 1993 Santa Cruz experiment to urge revenue producing districts to move away from property taxes, AB 1519 (Isenberg), Chapter 905, Statutes of 1993!

And some long term budget reforms...

The LAO recommends that the Governor's proposed constitutional and statutory changes be rejected. However, they propose a lot of major and serious changes (*P&I*, pps. 147-156). It is almost as if the LAO decided to cap the whole thing by urging changes in budget processing more expansive than proposed by the Governor. There is not enough time to do a detailed analysis, but here is a start:

- Phase in a higher state reserve—about \$2 billion higher.
- Make it harder for any Governor or Legislature to spend money in the Budget Stabilization Account.
- Set up an automatic method of transferring reserve funds in good budget years.
- Re-think (translation: "change or abolish") the crazy-quilt pattern of voter-approved tax spending (Props 99, 172, 10 and 63) and mandated state spending (Props 98, 42, 48, and 1A).

Wow! More later.

The California Budget Report is produced by Phil Isenberg and Maureen O'Haren of ISENBERG/O'HAREN. Questions, comments and requests to be added to the mailing list should be directed to Phil at phil@isenberg-oharen.com or Maureen at maureen@isenberg-oharen.com